GOVERNOR'S TRANSACTION PRIVILEGE TAX SIMPLIFICATION TASK FORCE

CONTRACTING WORKING GROUP MINUTES
Tuesday, October 16, 2012
1:30 PM
1820 W. Washington, St. #200, Conference Room 101
Phoenix, Arizona 85007

A public meeting of the Transaction Privilege Tax Simplification Task Force was convened on October 16, 2012 in Conference Room 101, 1820 West Washington, St. #200, Phoenix, Arizona 85007. Notice having been duly given. Present and absent were the following members of the Task Force.

Members Present	
Michael Hunter (Chair)	Steve Barela
Tom Belshe	Kevin McCarthy
John Olsen	Linda Stanfield
Miguel Teposte	Vince Perez
Keely Hitt	Senator McComish
Lynne Herndon	Representative Rick Gray

Members Absent

No members were absent.

Staff Present

Lindsay Scornavacco, Governor's Office

1) **Call to Order**
Michael Hunter called the meeting to order at 1:35 p.m.

2) **Analytical Framework for Transitioning from Contracting Taxes to Materials at Point of Sale**
Craig McPike, the Contracting Working Group Chair, asked members of the working group and of the public to contribute any numbers or information that could assist the Department of Revenue in their efforts to predict fiscal impacts.

a) **Presentation from Department of Revenue**
Elaine Smith from the Department of Revenue gave a presentation analyzing the transition from contracting to materials tax.

Vince Perez commented the materials use tax is not a new tax. The Department is contemplating a new class code to track the tax differently for potential distribution in the event there are changes to revenue sharing. Currently, all use tax monies are put into the General Fund.

Mark Minter from the Arizona Homebuilders Association commented that he has taken a sample of out-of-state versus in-state sales and found a very low percentage of sales to be from out of state.

Mr. McPike stated there is a range of 5-15% of materials bought out of state. In-state vendors appear to be bringing in the materials and selling them to contractors.

Christie Comanita from the Department of Revenue asked what materials were being brought in from out of state.

Mr. McPike gave steel as an example.

Mr. Minter stated the importation of steel is an anomaly because Phoenix has the one of the largest steel erectors. 80% of the imported steel gets dressed in Phoenix and is then exported out of state.

Kevin McCarthy asked if the Department of Revenue could identify the top three areas of construction activity.

Ms. Smith stated she will get that data, which is distributed almost monthly.

b) Presentation from League of Arizona Cities and Towns

Lee Grafstrom from the Unified Audit Committee stated he looked at revenues from FY12 and found that $168 million comes from total contracting revenues. He emphasized that FY12 was not a typical year and that this number is generally higher. Of the $168 million, $28 million came from speculative builder, $88 million came from general and prime contracting and $53 million came from trade and services. That amounts to 17% of total contracting revenues coming from the speculative builder category, 52% from general and prime contracting and 31% from trade and services. Mr. Grafstrom continued that for many of the small towns almost 100% of the revenues come from trade and services. No new homes are being built and there are no large construction projects. The vast majority of revenue will move out of cities with a shift to a materials tax at the point of purchase. Businesses will move out of the cities and into the counties to avoid paying city taxes. This would result in $170 million leaving the coffers of the cities. He stated anyone who can move will move. Revenue from construction activity that occurs in the bulk of the little towns will be shifted to larger cities. Smaller towns traditionally have the major portion of their revenues based in contracting will lose a larger percentage of their General Fund revenues.

c) Working Group Discussion and Public Comment

Mr. McPike clarified Mr. Grafstrom was describing a problem with a shift in revenues because of the city tax in addition to needed revenue sharing adjustments.

Mr. Grafstrom stated that was correct. There will be a pure loss of $170 million to all 91 combined cities. He repeated that this number came from a year that was abnormally low and stated that a normal year may be closer to $250 million in contracting revenue.

Representative Gray stated Mr. Grafstrom’s assumption is logical, but that he does not see it happening in practice. He stated he lives in a county island and does not see it happening.

Mr. Grafstrom responded it may not be the business that relocates, but the competitor that establishes itself outside of the cities to gain a competitive advantage. He continued that another problem the cities will face is that there are no retailers in the vast majority of the state that relies on contracting revenues. This shift will create the need for increased shared revenues.

Mr. McPike stated it is important to make a reasonable estimate of what the current level of noncompliance is and how that affects the equation.

Mr. Grafstrom commented that there may be some noncompliance at the state level, but he knows who the contractors are in the cities.

Mr. McCarthy asked Mr. Grafstrom if he believed the cities will lose the $170 million they are currently receiving because business will be incentivized to move out of the cities.

Mr. Grafstrom answered yes.

Mr. McCarthy stated Arizona is one of the most incorporated states in the union. The notion that everyone will close up their supply houses and take on all of the costs of moving does not make sense.

Mr. Grafstrom responded businesses will go where the costs are the least. He also stated Chandler is surrounded by a lot of unincorporated areas.

Mr. McCarthy asked if Mr. Grafstrom believes it will be 100% of businesses.

Mr. Grafstrom answered that the Lowe's and Home Depot's will stay in place, but small shops and large ticket retailers will explore that option.

Tom Belshe stated a relatively small number of retailers are selling most of these items.

Mr. Grafstrom commented there are a minimal number of suppliers for large items, but a ton of small plumbing contractors. He stated that the estimate is not a 100% loss of the $170 million. He continued that the vast majority of cities have no speculative builder, general contracting or retail outlets for construction materials. The construction activity there is weighted heavier because they have no retailers.

Mr. McPike stated there will be a hit to cities and towns under any scenario.

Mr. Grafstrom stated the Unified Audit Committee's biggest concern is shared revenue when contractors are taxed as retailers.

Mr. McPike commented there are other areas of the transaction privilege tax that this may simplify.

Mr. Grafstrom stated that states who tax contractors at the site have a much more complicated system than Arizona. The Unified Audit Committee is advocating for this to be done only for a couple of places to hold harmless all of the little towns. This would reduce the amount of shared revenue that needs to be backfilled. He continued that there are some ways to do it to create true simplification. A method could be to decide on a flat percentage for the value of materials. Large homebuilders could come to an agreement that 45% of the project is materials instead of counting every nut and bolt used. If a contractor's cost of materials is less than 45%, they can then keep track of the materials in detail.

Mr. McPike stated when contractors have the option to use the deemed percentage or to keep detail records to come in under that percentage, it makes it difficult to estimate how many people will take the easy route. The revenue hit could be significant.

Mr. Grafstrom stated his preferred choice is still to have contractors pay tax at the point of purchase with exceptions for small towns.

Linda Stanfield commented there would still be grey areas with the deemed percentage system that Mr. Grafstrom described. She continued that it would be very difficult to bring the idea to her employees and bookkeeper.

Spencer Kamps from the Homebuilders Association of Central Arizona stated he assumes the 45% limit would not apply to speculative builder.

Mr. Grafstrom stated that would have to be worked out. He asked how much materials were.

Mr. Kamps replied that it is the million dollar question. He continued that surveys have been sent out to get some data on the issue. There are varying percentages depending on the trade. He stated he hopes to come back to the working group with more information.

Mr. McCarthy asked if the 45% figure was a studied number or if it was chosen at random.

Mr. Grafstrom stated the Anderson study used 41.8% and that he looked at a couple of audits that showed between 46% and 51% for materials. He continued that he does not see increased shared revenue as an option when looking at $170 million, especially because usually it may be about $250 million. If that number can be brought to $75 million, it is easier to handle.

Steve Tofel, a private citizen, stated that in Tucson about 44% of the land is unincorporated. It would be highly likely for businesses to move to these areas in Tucson. Estimating that 100% of them will move is not reasonable, but there will be a loss of revenue. He also stated that he has 30-45 subcontractors and a dozen suppliers and it would be near impossible to keep track of all materials used. He stated he likes Mr. Grafstrom's idea of a two tiered system.

Mr. Minter stated he takes serious exception with the idea that businesses will relocate. Businesses stay in incorporated areas because it is convenient for the customer and they can get employees and products. When a vendor does businesses with contractors, it is a retail transaction that needs to be convenient. He continued that the big steel suppliers cannot pick up their entire operation and uproot a $50 million facility. They have to be near railways to be able to get materials in mass quantities. The idea they will relocate is false.

Mr. Kamps stated the assumption that everyone will move to a county island assumes that everyone is selling the same product. It would be highly unusual for suppliers to move to a location solely based on the cost of the tax rate. He continued that he appreciates Mr. Grafstrom's comments and that everyone understands the cities' concerns. He asked if the cities are ok with moving the contracting tax to the point of purchase if the financial impacts are addressed.

Mr. Grafstrom stated the Unified Audit Committee is open to whatever the Task Force is looking to do. He continued his goal is make sure everyone is mindful of the revenue impacts, but he knows there will be some losses. He is open to whatever changes will make things easier, fairer and will not devastate budgets of local governments. The only current option is to try and raise taxes in the communities that will accept it.

Mr. Belshe stated he was on a conference call with mayors and city managers and they expressed fear of the unknown. He explained there is worry about winners and losers and about how to explain that to the cities. Right now they have no information about the scope of the impact.

Representative Gray asked what cities will be affected that gain 100% of their revenues from contracting.

Mr. Belshe responded that he tried to work with Ms. Smith on this, but the data was not there. He continued that he is intimately close with the Town of Eagar and knows there have not been any new homes or new construction for a long time. Most of the activity is under trade and service. He stated he believes there is a way to make up losses with shared revenue and that a simple formula can be created to show small towns and cities the benefits of having construction in local communities.

Mr. Hunter stated he wants to be sure no one is losing sight of the overall task force effort of simplification. The labor has been divided into three working groups and there are opportunities for solutions to interrelate. He asked everyone to keep in mind there are issues in the other working groups that the Task Force has to grapple with.

Mr. McPike asked Mr. Belshe what would help the cities be more comfortable with the task force discussions.

Mr. Belshe answered it would help to know what other opportunities for revenue may be made available. It would also be helpful to know what a shared revenue system would look like.

Mr. McPike asked if anyone had thoughts on how to pull data on the locations of vendors around the state.

Mr. Hunter added that proxies and creative thinking would also be helpful for Ms. Smith to use as surrogate variables.

Mr. Belshe asked if there is a way to see from Mr. Minter's survey where the retailers are selling products.

Mr. Minter stated that is what he is trying to accomplish.

Mr. Belshe commented everyone used to think the majority of sales were made out of state and that has since been dispelled. The assumption is now that purchases are being made in only a few large cities. He continued it would be great to have an idea if that was true.

Ms. Smith stated this information would be extremely useful in determining how point of sale will affect county revenue sharing and city and county taxes.

Ms. Stanfield commented cities will compete to keep businesses.

Keely Hitt stated there are benefits cities provide to businesses that are being overlooked.

Mr. McPike stated there may be natural shifts over time of where new businesses decide to locate.

Ms. Comanita commented that when customers shop at a store they probably have no idea if it is located in a city or on a county island.

Mr. Minter stated often a consumer calls a store in one town, the product ships from another and the customer gets an invoice from a third location.

Mark Barnes from the County Supervisors Association stated it is difficult to determine what the revenue impacts on the counties will be from a long term perspective. There needs to be a mechanism for annual distribution to counties to make up for the loss and hold them harmless.

Mr. Hunter interjected there needs to be a limit on how many times everyone can use the phrase "hold harmless." There is a lot of change happening outside of this reform effort, changes to the tax base and changes at the Legislature that sometimes benefit the counties and sometimes do not. He continued that benefits to different parties are not always a part of the dialogue when discussing good tax policy.

Mr. Barnes presented a handout to the working group.

Mr. Grafstrom clarified where the tax dollars would go in Mr. Minter's example of having three different locations. The city tax applies where the order is received. If the permanent business is outside of the city then there is no city tax. A business would not have to move the entire steel plant, but only the sales office.

Mr. McCarthy asked Mr. Grafstrom if as an auditor he would allow such a tax avoidance scheme to happen. He commented that first the theory was that 100% of businesses would move and now that they all will set up tax avoidance schemes that would be pursued as illegal.

Mr. Grafstrom stated even if the tax avoidance is illegal it forces the issue back in court where superior nexus must be argued.

3) Topics for Future Working Group Meetings

Mr. McPike stated the next working group meeting will be on November 20th.

a) Working Group Discussion and Public Comment

No comments were made.

4) Adjournment

Mr. Hunter adjourned the meeting at 3:25 p.m.